HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

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October 2, 2002

Renewed Stock Market Weakness
Could Make the Budget Deficit Even Larger

> "The stock market and the capital gains receipts it generates have become more important than ever to the federal budget outlook. Their volatilities and uncertainties merit a very close inspection by those who participate in the budget process."

President Bush's *Mid-Session Review of the Budget*, page 6
July 15, 2002

Dear Democratic Colleague,

After a brief rally in September, the stock market has again weakened, as evidenced by the attached article from yesterday's *Washington Post*, and the S&P 500 now stands 45 percent below its peak in early 2000. As detailed below, this market decline promises to have severe and enduring consequences for the budget deficit.

Both CBO and OMB have argued persuasively that last year's drop in stock market values caused a sharp falloff of revenues last April 15 — a falloff that significantly exceeded the GDP decline in the recession. This year's market decline will have a similar impact on revenues this coming April even if the market now recovers. Still more troubling, the low level of share prices is likely to hold down revenues — and widen deficits — for a number of years, except in the unlikely event that the market immediately soars back to its peaks of two years ago.

Today's Mirror Image of Trillion Dollar Upward Revisions in the 1990s

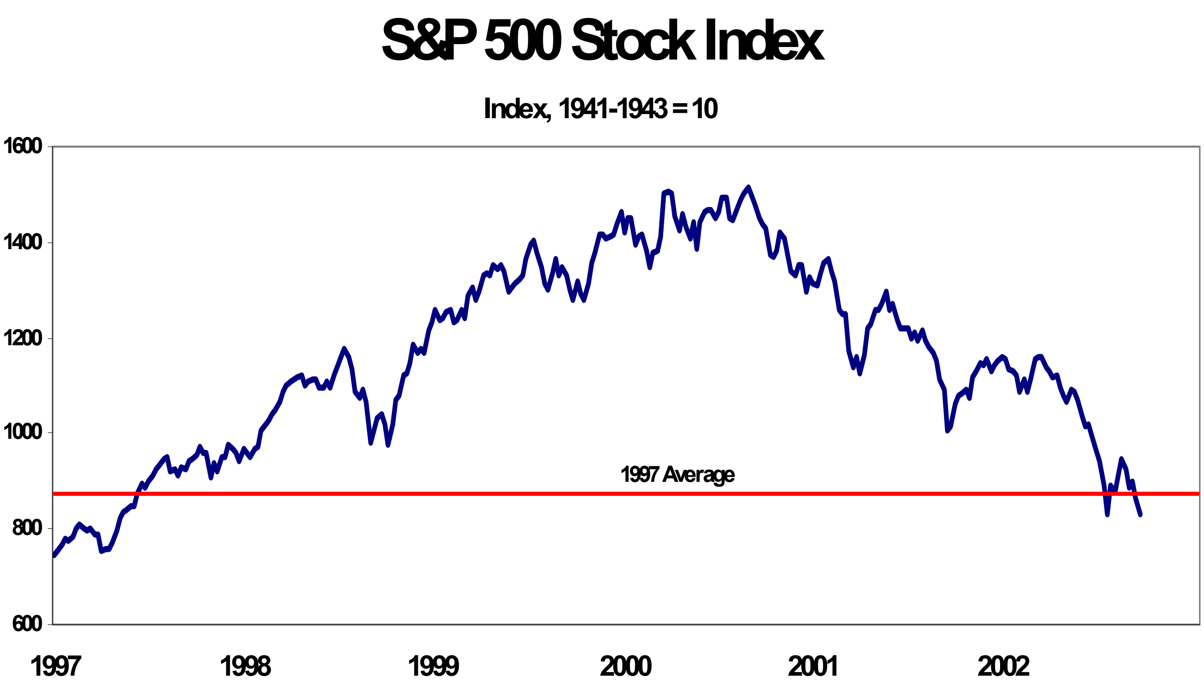
> "The current [revenue] shortfall represents the mirror image of the revenue explosion of recent years... The strength in individual income tax receipts traced very directly to a period of remarkable stock market gains."

President Bush's *Mid-Session Review of the Budget*, page 3
July 15, 2002

Between January 1997 and January 2001, so-called "technical" factors pushed ***up*** CBO's forecasts of the ten-year surpluses by an average of $764 billion per year. To a great extent, these technical revisions reflected the fact that revenues were growing well in excess of GDP growth, and subsequent analyses by both CBO and OMB showed that the surging stock market played a leading role in these upward revisions.

In the year and a half since January 2001, technical factors have pushed ***down*** ten-year projections of the budget. Between January 2001 and January 2002, technical factors reduced the 2002-2011 projection by $659 billion, and then this summer, technical revisions pushed down the projection for 2003-2012 by $963 billion.

Although these technical revisions apply to different ten-year spans because the budget window shifts forward each year, the magnitudes do suggest that downward technical revisions seen thus far may have retraced only about half of the upward revisions in the 1990s. Certainly, if the stock market fails to recover — with the S&P 500 currently hovering near its level in 1997 when the large upward technical revisions began — we should not be surprised by a further deterioration of the ten-year budget outlook on the order of $1 trillion or more.



Budget Effects of the Market Plunge Will Persist Even with a Recovery

> "[I]t is unclear whether the stock market will rise sufficiently to generate the higher level of revenues experienced in the late 1990s, or follow a more traditional pattern... The decline in the stock market has generated an enormous

> amount of capital losses... [T]here is an annual limit of $3,000 on losses that can be used to reduce ordinary taxable income, meaning that there probably is a sizable amount of realized capital losses that taxpayers are carrying forward into next year and into years beyond."

President Bush's *Mid-Session Review of the Budget*, page 5
July 15, 2002

Even if the S&P 500 index recovers its January 2002 level by the end of the year (that is, a 40 percent increase over the next three months), the average for 2002 as a whole would still be 12 percent below the 2001 average. Tax filings next April will be based on taxable incomes for calendar year 2002, which therefore suggests that revenues on income related to the stock market — like capital gains, stock options, and executive bonuses — could again be exceptionally weak next year. This calls into question the Administration's prediction that the budget deficit will abruptly shrink next year to $109 billion from this year's $165 billion shortfall.

Worse still, as the President's *Mid-Session Review of the Budget* points out, the capital losses taken by unlucky investors last year and this year are likely to weigh upon the budget deficit for some years to come. Timing of capital gains realizations and the exercise of stock options cannot be known precisely. However, it seems quite plausible that revenues from incomes related to the stock market will remained depressed for at least a few years as capital losses of the last two years are carried forward and stock options are not exercised. Certainly, if the market stays relatively flat for some time — remaining well below its peaks of the 1990s for several years — we could see downward revisions of the budget outlook for a prolonged period.

The Weakness of Revenues Related to the Stock Market Was Predicted

Three reports by the Democratic staff of the Budget Committee — on March 12 and December 13 of 2001 and again on May 9 of this year — specifically warned about precarious budget projections premised on an assumption that a strong stock market would continue to boost revenues. These warnings were ignored, and Republicans pushed through a budget that left no room for error. In fact, House Republicans' budget resolution last year even provided a reserve fund for additional tax cuts in the event that CBO once again revised up its projection of the surplus. Unfortunately, the revisions have been in the opposite direction, as may well be the case now for some time.

Sincerely,

John M. Spratt, Jr.
Ranking Member

For Dow and S&P, Worst Quarter Since '87

Indexes Continue to Fall as Economic Data Disappoint

By a Washington Post Staff Writer
Tuesday, October 1, 2002; Page E01

The stock market ended its worst quarter since the crash of 1987 yesterday, with losses in all three major indexes blamed on sluggish consumer spending, slashed earnings forecasts and fears of an impending war in Iraq.

After five straight weeks of losses, the S&P fell 12.09 points yesterday, or 1.5 percent, to 815.28, with almost three-quarters of its member companies reporting declines. The Dow fell 109.52, or 1.4 percent, to 7591.93. And the technology-heavy Nasdaq composite index slipped 27.10, or 2.3 percent, to 1172.06, a six-year low.

Both the S&P and the Dow lost 18 percent over the past three months -- their worst quarterly performances since the fourth quarter of 1987, when the S&P plunged 23.2 percent and the Dow dropped 25.3 percent.

"It's a tombstone rather than a milestone," said Al Goldman, chief market strategist at A.G. Edwards in St. Louis. "The biggest problem is mood. Investors are distressed, despondent and mad. It's

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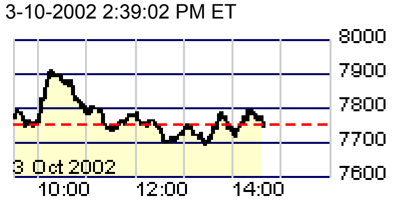
DJIA | S&P 500 | NASDAQ

Dow Industrials
3-10-2002 2:39:02 PM ET



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DJIA	7,752.22	-3.39
S&P 500	823.32	-4.59
NASDAQ	1,176.07	-11.23

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understandable after two years of a very tough environment."

The government reported yesterday that personal income and spending, which have propped up the economy through last year's recession and this year's spotty recovery, grew only slightly in September. Income rose 0.4 percent in August, and spending increased a meager 0.3 percent.

"We have an economy that is a stool with a single leg -- the consumer," said Jeff Swensen, senior trader at John Hancock Funds in Boston, who identified the other two missing legs as job creation and capital expenditure. "Everyone is relying on the consumer to keep spending, but it's getting more and more likely the consumer is going to slow down."

Corporate earnings news remained sour among industry bellwethers.

Both high-end and popularly priced retail chains cut their sales forecasts yesterday, and investors responded with sell orders. Shares of Wal-Mart, a Dow industrial, dropped $2, to $49.24, after the company trimmed its predicted sales gains for stores open at least a year to 6 percent from 4 percent. Shares of J.C. Penney lost $1.68, to close at $15.92, after the retailer said same-store sales probably fell last month.

Shares of Walgreen, the country's largest drugstore chain, fell $3.13, to $30.76, after the company announced that it had earned 24 cents a share in its fiscal fourth quarter, a cent less than analysts had forecast. Credit Suisse First Boston lowered its rating on the drugstore, and its rivals' stock quickly dove. CVS dropped $2.04, to close at $25.35, and Rite Aid fell 18 cents, to $2.10.

"If you are a company, it is impossible to improve your bottom line in a

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• How He Did It: Rate cut timeline since the last recession.
• Effects of a Rate Cut
• Effects of a Rate Hike
• Federal Reserve Special Report

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painless way right now," said Stephen Stanley, an economist at Greenwich Capital Markets in Connecticut.

The technology sector also suffered. Shares of the world's largest chipmaker, Intel, fell 73 cents, to $13.89; computer maker Dell fell 68 cents, to $23.62; and IBM fell $1.35, to $59.01.

The news on the factory floor was not much better. The National Association of Purchasing Management-Chicago said its factory index, a measure of manufacturing activity in the Chicago region, fell to 48.1 this month from 54.9 in August. The drop brought the index below 50, a signal of economic contraction, for the first time since January.

"The worry is that the production and manufacturing side of the economy is just not coming back," said Robert W. Bissell, director of portfolio management at Wells Capital Management in Los Angeles.

"These numbers are not a surprise, but they could eventually spell lower earnings," he said.

The day's losses followed declines across the Atlantic. All 17 benchmark indexes in Western Europe slid yesterday. Britain's FTSE 100 fell 4.8 percent, Germany's DAX index lost 5.1 percent, and France's CAC 40 index shed 5.9 percent. Stocks also fell in Asia's two largest markets, Japan and Hong Kong.

Other Indicators

• The New York Stock Exchange composite index fell 4.79, to 445.44; the American Stock Exchange index rose 2.97, to 827.28; and the Russell 2000 index of smaller-company stocks rose 0.49, to 362.27.

• Declining issues outnumbered advancing ones by 4 to 3 on the New York Stock Exchange, where trading volume rose to 1.86 billion shares, from 1.52 billion on Friday. On the Nasdaq, decliners outnumbered advancers by 11 to 9 and volume totaled 1.59 billion, up from 1.4 billion.

• The price of the Treasury's 10-year note rose $5.63 per $1,000 invested, and its yield fell to 3.59 percent, from 3.66 percent on Friday.

• The dollar fell against the Japanese yen and the euro. In late New York trading, a dollar bought 121.78 yen, down from 122.84 late Friday, and a euro bought 98.63 cents, up from 97.95.

• Light, sweet crude oil for November delivery settled at $30.45 a barrel, down 9 cents, on the New York Mercantile Exchange. Gold for current delivery rose to $323.90 a troy ounce, from $319.70 on Friday, on the New York Mercantile Exchange's Commodity Exchange.